

## The battle for Asia in crude oil markets: an easier road ahead for India?

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Two significant events which occurred in the oil market in 2014 have the potential to reshape India's historical struggle with oil and fiscal deficits. The first is the complete deregulation of major petroleum products prices and the second is the sharp fall in oil prices amidst a fight for market share in Asia among crude producers, implying importing countries like India are now spoilt for choice and in a far better position to bargain for better prices. Even though the drop in prices is unlikely to last (given the high cost on the supply side) and prices are likely to pick back up to at least the US\$80–100 per barrel range in the coming years, India will remain in a privileged position compared to a few years ago, as the continued growth of US tight oil means producers from all around the world will still focus on Asia to sell their crude. This, together with the deregulation of product prices, will help boost Indian fiscal balances immensely, in a complete reversal of the trend seen over the past decade.

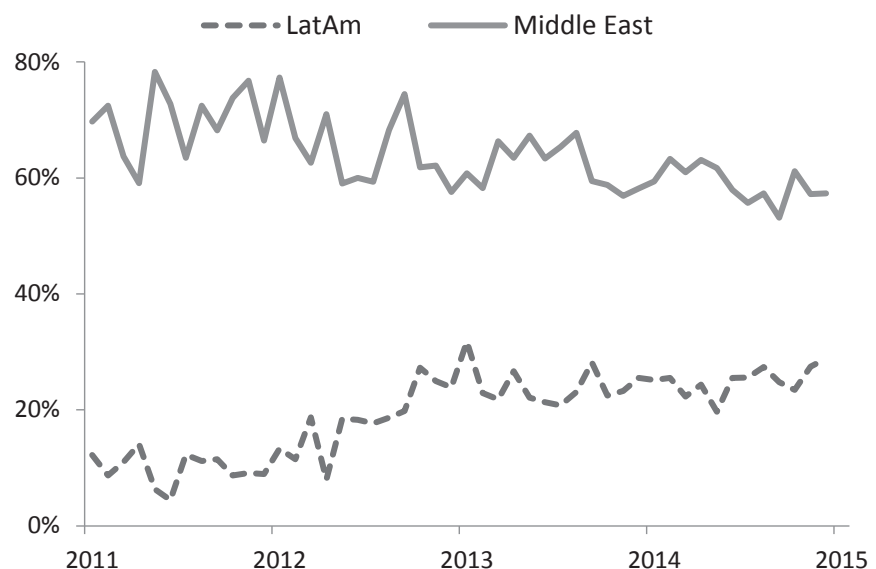
### Growing market share in Asia and falling crude prices

In fact, a large part of today's oil price drop stems from Middle Eastern crude facing growing competition in Asia. Traditionally, Asian crude primarily came from the Middle East, but now sellers to Asia span the FSU, West Africa, Latin America, Canada, and the Middle East. With the centre of gravity for global refining moving to the East of Suez and the tight oil supply growth in the USA backing out imports from traditional suppliers such as Nigeria and Mexico, Asia has become the main destination for current oil exporters. Anecdotally, Latin American crude is being sold to India at a discount to Dubai prices as, following the backing

out of West African crudes, LatAm exports to the USA are starting to face the heat from growing US domestic production. Indian imports of LatAm crudes have risen from 10 per cent of total imports in 2011 to 15 per cent in 2012, to 20 per cent in 2014, reaching a record high of 0.88 million barrels/day (mb/d) in December 2014. Venezuela, Brazil, and Colombia are likely to see further gains in 2015, especially with the start-up of the long delayed 0.3 mb/d Paradip refinery in Q2 15, with collective year-on-year (y/y) increases potentially in the range of 0.1–0.15 mb/d. Over the same time period, Middle Eastern exports have fallen from 70 per cent of total Indian imports in 2011, to 59 per cent in 2014. Given a similar trend across Asia, this has forced Middle Eastern producers to discount their crude to Asia, their biggest export market, in order to maintain market share.

But the competition does not stop here. Another strand of growing competition

for crude exports to Asia comes from within the Middle East itself. Rising Iraqi production and deep discounts offered by the Iraqi oil marketing company SOMO, partly due to variability in crude quality, have meant rising Iraqi exports to Asia, displacing those from Saudi Arabia. This has become a bone of contention for Saudi Arabia. According to some assessments, China's position in the Iraqi oil industry is such that at least one third of all future production of Iraqi oil will be derived from oil fields operated wholly or partially by Chinese concerns or where they have a stake. Similarly, since the 2012 sanctions, Iran has also discounted its crude heavily, in order to entice buyers such as India and China to continue taking its crude. For example, in 2014, Chinese crude oil imports rose y/y by 0.53 mb/d and yet imports from Saudi Arabia averaged less than 1 mb/d and were lower y/y by 85 thousand b/d. In contrast, China's imports from Iraq rose by 0.1 mb/d, while those from Iran averaged 0.12 mb/d



**Changing proportions of crude imports, Latin America and the Middle East, 2011–15**

Source: Reuters and Energy Aspects

higher y/y. Similarly, Indian crude imports averaged around 3.8 mb/d, slightly higher y/y, yet those from Saudi Arabia fell while imports from Iran rose by 87 thousand b/d y/y. In fact, since 2012, Saudi Arabia has gained none of the at least 1 mb/d increase in Asian crude imports.

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**'A SHARP FALL IN OIL PRICES IS A BOON FOR IMPORTING COUNTRIES LIKE INDIA (WHICH ... COULD SEE ITS IMPORT BILL HALVE IN 2015)'**  
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In a falling market, there are limits to how much Saudi Arabia is willing to lower its output, especially if the OPEC members that have been taking market share from the Kingdom do not follow suit. This is exactly what we saw in late 2014, as OPEC failed to bridge the gap between GCC members (led by Saudi Arabia) and the others to agree a collective cut in production. History repeated itself as Saudi Arabia did not acquiesce to large Iraqi or Iranian output increases and instead left it to the market to find a floor for prices. At that critical point, Saudi Arabia abandoned the role of the swing producer and is competing to maintain its market share, raising exports in November and maintaining production steady at 9.6 mb/d. Of course, growing competition in Asia was not the only reason for Saudi Arabia to demand a collective cut; there was a broader issue about it simply refusing to take on the burden of the production cut and continue to guarantee a return for the rest of the oil industry at the expense of its own market share. But clearly, the two are linked. So, not only has this led to a sharp fall in oil prices which is a boon for importing countries such as India (which imported nearly 4 mb/d of crude at a cost of approximately US\$146 billion in 2014 and could see its import bill halve in 2015), it highlights the extent to which

producers now have to discount their crude to gain a foothold in Asia, relative to the premium they used to charge.

At the same time, the move by the Indian government to remove all subsidies when prices were still at US\$100/barrel (a move we do not see changing even with the drop in prices) will also help strengthen public finances.

#### Removal of subsidies

Subsidies on petroleum products have historically made a significant contribution to India's fiscal deficit. For over a decade, Indian policy makers have been grappling with pricing reform, but these efforts have faced challenges. In response to rapid oil price rises since 2004, gasoline prices were liberalized in 2010. However, diesel price liberalization was not taken up for a further two years, largely due to inflationary concerns and potential voter backlash, given a much wider consumer base for diesel relative to gasoline, and its heavier usage, particularly in goods transportation. Indeed, diesel formed roughly 38 per cent of petroleum product consumption in 2010 compared with 9 per cent for gasoline. Estimates suggest the trucking sector represented roughly 37 per cent of diesel consumption, followed by passenger cars at 15 per cent, agriculture at 12 per cent, buses at 12 per cent, industry at 10 per cent, power generation at 8 per cent, and railways at 6 per cent.

But worsening public finances ultimately resulted in the government announcing a 14 per cent increase in the price of diesel (to US\$0.89 per litre) in September 2012, which was necessary to bring down the fiscal deficit, and to improve investor confidence, so the current account deficit could be financed increasingly

through foreign investment inflows rather than the drawing down of foreign exchange reserves.

By late 2014, the Indian government had fully liberalized diesel prices, allowing the market to set retail prices, and opening the door for some of India's export-oriented refineries to re-enter the domestic market after a six-year absence. Regular increases in regulated prices had brought pump prices in India near international levels earlier in 2014, leading to widespread expectations that the market would be liberalized, following the ending of price controls on gasoline a few years before.

The fact that Indian diesel prices had already been pushed up to near international levels before the formal announcement of a fully liberalized diesel market and the recent fall in international oil prices means there is unlikely to be a material negative impact on Indian diesel demand. In fact, income elasticity in the period between 2005 and 2013 was close to 1 whilst price elasticity was close to zero. This means that, contrary to the popular argument that oil demand in developing countries will fall substantially if petroleum product prices are raised, the removal of subsidies is unlikely to have a big impact on oil demand given the high income elasticity at India's current level of economic development.

However, rising diesel prices have resulted in a shift away from diesel-powered vehicles towards cheaper gasoline cars as car owners scrap older diesel cars, in a reversal of the trend seen during 2010–13. We expect the share of diesel-powered passenger vehicles to fall from 55 per cent to 35 per cent. So, increasingly, diesel's usage will be concentrated in commercial vehicle



sales (which account for almost 40 per cent of diesel demand), rather than passenger cars, while it will remain the fuel of last resort at the margin at times of blackouts due to coal shortages or poor monsoons, when back-up generators are used for irrigation and power generation purposes.

Interestingly, India's federal government has taken advantage of falling oil prices to boost revenues from fuel taxes four times since November, in the form of consumption tax increases. While the drop in prices has been bigger than the rise in taxes, it is clear that the government is keen to keep consumption growth in check by limiting the impact of the sharp fall in oil prices for consumers. Part of this is driven by environmental concerns, while a larger part aims to boost public finances, and the government is unlikely to reverse these taxes even when prices come back up. Combined, the four tax hikes, which will fund infrastructure construction, have pushed up excise duties on gasoline by 7.75 rupees per litre (US\$19.92 per barrel at the current exchange rate) and 6.5 rupees per litre for diesel (US\$16.71 per barrel). Yet, this will be supportive for diesel demand going forward, as construction activity picks up.

Indeed, after Indian diesel demand declined across 2013 and was lacklustre in 2014, we expect the new norm for growth to be around 2–3 per cent, primarily supported by improvements in economic growth and construction work, despite the subsidy removal.

Of course, the failure of the previous effort to liberalize the diesel market (after prices soared in 2008) serves as a reminder that this step can be undone and India may revert to a subsidized market in the future. Given the politically sensitive nature of diesel prices – due to its use as a swing fuel during power and water shortages particularly in agriculture – a return to price controls cannot be ruled out, although a more likely option would be for the government to give targeted subsidies to farmers. Indeed, farmers could receive some sort of subsidy if crude oil prices were to experience a sharp rise back above US\$100 per barrel, which would be supportive for Indian diesel demand. Diesel is likely to remain a swing fuel at times of droughts and power shortages (thus maintaining its political sensitivity) but we do not expect the return of large-scale subsidies or the removal of the consumption taxes.

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**'... MARKET LIBERALIZATION WILL INCREASE COMPETITION IN THE DOMESTIC MARKET.'**  
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Finally, market liberalization will increase competition in the domestic market, allowing refiners such as Reliance and Essar to reopen their domestic retail networks and compete for market share – after private refiners had closed networks following previous failed attempts to liberalize diesel prices in 2008. The diversion of some of the supplies from export-oriented refiners to the domestic market is mildly supportive for Asian diesel prices, as we expect these firms to capture a sizeable share of the domestic market (10–20 per cent), displacing supply from some of India's state-owned refiners.

**Conclusion**

While deregulation of the Indian market began before the decline in oil prices, the government has been able to go further and faster as a consequence. As competition between crude producers for Asian market share is set to continue and the Indian government is unlikely to reverse recent subsidy and tax changes, benefits to the Indian fiscal balance will continue even after global oil prices rebound from the current low levels.

